Manitoba
Agriculture

Capital Gains and Losses

nformation Update

Introduction:

Date: December, 2000

This **Information Update** defines the general terms of Capital Gains and Losses in the context of Canada's income tax legislation and how this can potentially affect the taxpayer. The regulations that govern this legislation are reviewed so as to understand, via some examples, the potential impact this may have when selling and/or transferring farm assets.

During the 2000 year there have been changes to the Capital Gains inclusion rate as Federal Budget changes occurred on February 27, 2000 and October 18, 2000. The Capital Gains inclusion rate chronology was as follows:

***Prior to February 27,2000** – 75%*
***Between February 27, 2000 and October 17,2000** – 66 2/3%*
***On or after October 18, 2000** – 50%*

If you have a situation that might involve a Capital Gain/Loss, it is strongly recommended that professional taxation and legal advice be obtained to manage the potential taxation liability that might occur.

In addition, income derived from a Capital Gain may trigger clawback of Old Age Security (OAS) benefits and also affect Pharmacare benefits in the province of Manitoba. Tax legislation changes from time to time, and the information contained in this Information Update is based on the prevailing tax legislation information at the date of publication.

The Capital Gain subjects covered in this publication are:

- Capital Gains and Losses Defined
- What is Capital Property
- Capital Gains Exemption
- Valuing Capital Property
- Individual Capital Gains... An Example
- Capital Gain Reserves
- Principal Residence Exemption
- Other Capital Gain Notes

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Capital Gains and Losses Defined:

The concept of Capital Gains and Losses came into being with tax reform legislation introduced in 1971. The general concept of a Capital Gain or Loss is simply the difference between the original cost of an asset and what the asset sold for upon disposal (including any outlays or expenses in selling). If the difference is negative this is a Capital Loss and can be used to reduce other Capital Gains. However, if the result is positive this difference is called a Capital Gain and is taxed as income when it is incurred.

At the present time, 50% of a Capital Gain is taxable income while 50% of a Capital Loss can be used to reduce a taxable position. The Capital Loss can be applied against a Capital gain in a current taxation year or be carried back three years and applied. The Capital Loss can also be used against a taxable capital gain in a future year.

What is Capital Property…

Capital Property is the assets a farmer or individual has in their possession. Some examples of Capital Property owned by farmers are:

- Farmland and improvements
- Buildings
- Machinery, equipment, vehicles, etc.
- Farm homes
- Stocks, Bonds and other Securities
- Personal Use Property such as boats, summer cottages, automobiles and other such assets.
- Listed personal property - coins stamps, rare books, jewelry, drawings, paintings, or sculptures.
- Basic livestock herd
- Milk quota or other "government rights" or licenses of a similar nature.

Capital Gains Exemption:

Before we go further it is important to mention at this point **that current tax legislation does allow a cumulative Capital Gains Exemption to a maximum of $500,000 only on Qualified Farm Property.** There has been much discussion in the last couple of years on whether the Federal Government will continue to allow this exemption to continue. The debate continues and this will remain a tax tool for the individual farmer until it is eliminated.

The maximum Capital Gains deduction you can claim for the disposition of qualified farm property is $250,000 ($500,000 * 50%) minus any Capital Gains deduction you claim for other properties.

Qualified Farm Property is defined as capital property you or your spouse own and includes:

- Real property such as land and buildings;
- Eligible capital property such as milk and egg quotas;
- Shares of the capital stock of a family farm corporation that you or your spouse owns; and
- An interest in a family farm partnership you or your spouse own

Qualified farm property must be used by:

- You, your spouse, or any of your parents or children;
- A family farm corporation where any of the above persons owns shares of the corporation; or
- A family farm partnership where any of the above persons owns an interest.

This provides a general overview of the exemption and other lesser defining details will be reviewed later in this article.

How Do You Determine the Value of Capital Property...

The tax legislation of 1971 provides certain guidelines to determine the property values on which the following calculations are based. What constitutes **Disposition of Capital Property** is defined as well as the concepts of **Valuation Day Values** and **Median Amount,** which determine an adjusted cost base for property owned prior to December 31st, 1971.

A. **Disposition of Capital Property** is deemed to have occurred if one of the following has transpired:
   - Property is sold.
   - Property is gifted.
   - The owner of the property dies.
   - Property is taken unlawfully.
   - Property is expropriated.
   - Property is destroyed and insurance proceeds are received.
   - Property is transferred to a trust, corporation or partnership.

B. **Valuation Day** was set by the tax reform legislation of 1971. Basically, it determined that December 31, 1971 was the beginning point in time that any future increases in asset/capital property values would be measured, if they were owned prior to this date. For assets/capital property bought after this date, the cost base is the price paid for the item at that time. For property bought and owned prior to this date the cost has to be determined by a valuation process as of December 31st, 1971.

An example of this: let's say a farmer purchased a piece of land in 1964 and sells or disposes of the same property this year. The first step in calculating whether there is a Capital Gain or Loss is to determine this property's value as of December 31,1971. This can be done by:

- **Documentation** – information on asset values for December 31st, 1971 is still available. Revenue Canada does have a data collection of land values by Rural Municipality for '71 and '72 that can be used to provide the information required.
- **Photos** – can be used to portray the condition of an asset at or near valuation day.
- **Information Regarding Neighboring Properties** - includes property conditions and prices can also provide a basis for your own valuation. Comparable sales information is also available from Revenue Canada.
- **A Formal Appraisal** – this can be done if the property value is significant. The appraisal cost should be determined prior to using an appraiser to determine the benefits. However, it may be necessary particularly if the land value is being affected by urban encroachment.

Through this process the farmer arrives at the Valuation Day value for the land bought in 1964. This valuation process is the same when other assets such as equipment, etc. are sold or disposed of as well.

If you still have assets that were owned prior to the December 31st, 1971 date, it is suggested that the valuation process should be done as soon as possible. Accurate valuations of assets tend to become more complex and potentially expensive as each year goes by. In the event of an estate settlement, this is also one less item that the estate has to contend with to successfully complete their duties.

C. The **Median Rule (also known as the tax-free-zone method)** is another valuation process allowed by Revenue Canada which takes the median of the original cost, Valuation Day value, and the disposition value (*Corporations are required to use the Median Rule*).Using our previous land example to illustrate this:

Original Cost of Property in 1964	-	$15,000
Valuation Day Value for 12/31/71	-	$28,000
Disposition Value	-	$65,000

Using the Median Rule, the **Adjusted Cost Base (ACB)** for this example would be $28,000. With a disposition value of $65,000 the Capital Gain is $37,000 ($65,000 - $28,000) for the land.

It is up to the taxpayer to decide which valuation method to use in determining the Capital Gain. If a Valuation Day method is chosen to value capital property owned on December 31st, 1971 then this method must be used on all dispositions of the capital property. Similarly, if the Median Method is the chosen way to value the capital property on Valuation Day it must be used an all dispositions of the capital property.

Individual Capital Gains Exemption ... An Example

For illustration purposes, this example consists of two components that arise in considering tax implications.

1. Suppose that an individual has disposed of a piece of land, the N1/2 of 1-1-1 ZPM for $136,000.

2. In addition a piece of equipment is sold for $75,000 with $50,000 of Undepreciated Capital Cost in the associated CCA class.

Let's deal with the tax issue surrounding the land sale first:

- The property was bought for $27,000 in 1968.We have had to do our homework in determining the value as of December 31st, 1971 for its adjusted cost base. According to the comparable sales at that time, the Valuation Day value is $50,000. The real estate commission came to $6,000, which is included in the overall calculation for disposal costs.

Legal Description Of Property - N1/2 1-1-1-ZPM	
Bought in	1968
Disposition Proceeds	$136,000
Original/Adjusted Cost Base	$50,000
Less – Outlays/Expenses	$6,000
Net Proceeds (Gain/Loss)	**$80,000**

Based on year 2000 tax calculations, the Taxable Capital Gain of 50% of $80,000 is $40,000. **The Capital Gain Exemption on the land is then calculated on Form T657 of the Revenue Canada T1 Schedule. The result is that 50% of $80,000 yields the figure of $40,000 that is entered on Line 127, page 2 of the T1 Schedule.**

- Our next calculation is the equipment sale. The original cost of the equipment was $100,000 with **undepreciated capital cost allowance (UCC)** of $50,000 for income tax purposes.

  The recapture of capital cost of $25,000 in this example is the difference between the $75,000 sale (disposition) and the undepreciated capital cost allowance. **The $25,000 is added to the taxable gain on Land , $40,000, for Total Income of $65,000. For our example, this figure is entered on Line 150 of the T1 General Form.**

  Note that machinery is <u>not eligible capital property,</u> and therefore, the Capital Gains exemption cannot be applied to minimize tax on the machinery sale.

The end result is that the land sale proceeds are sheltered under the Capital Gains Exemption because the land is defined as Qualified Farm Property, while the Equipment sale with the $25,000 recapture of capital costs are fully taxable and entered on Line 260 of the T1 General Form.

Our example indicates that the Total Taxes owed by the farmer are $8,421. The Federal tax bill is comprised of $2,744 and $1,677 CPP contributions. **(Note: The Manitoba Provincial Net Income Tax and Surtax are to be eliminated by 2001 when new provincial tax calculations are implemented. The Federal Surtax will also be phased out over the next five years as well. In addition for 2001, new federal tax rates will also apply based on the proposed October 18, 2000 budget.)**

The Manitoba Surtax is based on the Manitoba net income tax that is 2% of adjusted net income as shown in our example. With a basic credit of $600, the Manitoba Surtax payable is shown as $700. For our example, the Provincial tax due is $4,000 and is comprised of the basic Manitoba Tax of $2,000, Manitoba net income tax of $1,300 and the surtax.

Additional information on Alternative Minimum Tax, Manitoba Income Tax and Surtax can be found in the Information Update publication – Alternative Minimum Tax.

Capital Gain Reserves

When property is sold, full payment is usually made at the time of the sale. However, when there is a sale where the proceeds are received over time, a **capital gain reserve** can be declared. This allows the deferral of the capital gain to the year in which you receive the proceeds. To claim a capital gain reserve, Form T2017, is filed with your tax return in the year the reserve is declared.

There are two formulas to be followed if your property is sold after **November 12, 1981**:

A. **Family farm property, small business corporation shares, or an interest in a family farm partnership** sold to your child who lived in Canada at the time of the sale for tax purposes. Your child is defined as:
   - your natural child, adopted child, or your spouse's child.
   - your grandchild or great grandchild.
   - your child's spouse.

   When one of these three types of property is sold after November 12, 1981, the capital gain can be spread over 10 years. You must report at least one-tenth of the capital gain each year until the entire maximum reserve is the lesser of:

   1. Capital Gain times: Amount Payable after end of the year / Proceeds of Sale

or

2. Capital Gain times:

Percentage	Year
90%	1st year (year of sale)
80%	2nd year
70%	3rd year
60%	4th year
50%	5th year
40%	6th year
30%	7th year
20%	8th year
10%	9th year
0%	10th year

B. **Other Capital Property** – for all other capital property that you sell after November 12,1981, the capital gain can be spread over a maximum of five years. At least 20% of the capital gain must be reported each year until the entire capital gain is reported.

Principal Residence Exemption

Capital gains realized by individual taxpayers from the sale of a home are tax-free. Further information on this topic is contained in Revenue Canada's information bulletin, #IT-120R4.

To qualify as a principal residence, four requirements must be met:

1. The property must be a housing unit and includes the land it stands on up to one acre.
2. The property must be owned by the taxpayer or jointly with another person.
3. The property must be ordinarily inhabited by the taxpayer during each year that it is claimed as principal residence. Seasonal residences might qualify.
4. The property must be designated as a Principal Residence. When the residence is disposed of, Form T2091 is required in the year of disposal with your tax return. If none of the gain is taxable, the form is not required to be filed with the return.

In general, if your property qualifies as a principal residence throughout the period you own it; the capital gain is tax-free.

Special Alternatives for Farmers

Farmers are allowed two ways in which to calculate the exempt gain on the principal residence:

1. Upon sale of the farm it is hypothetically divided into 2 parcels. The farmhouse consists of one parcel which also includes one or more acres which "contribute to its use and enjoyment". A reasonable allocation of the overall sale proceeds is then made between the two parcels. The same allocation is made on the "adjusted cost base of the property. Taxable gains are then calculated for both parcels with the residence portion likely ending up exempt from capital gains.

2. The capital gain is calculated for the whole property. The capital gain is then reduced by $1000 plus $1000 for every year that the house has been the principal residence since December 31st, 1971. Part years are considered full years and the farmer must file a special letter with the tax return under this option.

The method that provides the largest exemption to the farmer can be used.

Principal Residence Example: A farm sale of $400,000 has occurred. When the farm was purchased in 1971 the value placed on the house was $30,000, with the land value at $200,000. The estimated value of the house now is $50,000. Using the two methods allowed:

Hypothetical Division

Total Capital Gain	-	$200,000
Capital Gain on House portion	-	$20,000
Principal Residence exemption	-	$20,000
Net Capital Gain	-	$180,000

Total Gain less ($1000 plus $1000 per year)

Total Capital Gain	-	$200,000
2000-1971 = (29 yrs x $1000) + $1000 =		$30,000
Capital Gain Exemption	-	$30,000
Net Capital Gain	-	$170,000

Farm corporations and partnerships are not allowed to own a principal residence that is given tax-exempt status. If exempt status is desired, the house and parcel of adjacent land should be separated and be kept out of the formation of a corporation or partnership.

Claiming home expenses each year may affect the tax-free status of capital gains on the home. If capital cost allowance has been claimed for 25% of the capital cost of the home as a business expense, then 25% of any capital gain realized on the home portion will not be exempt from taxation. Unless the farm is in an area affected by urbanization, the greatest tax advantage will still likely be to deduct a yearly business expense, including a capital cost allowance, on a portion of the house expenses.

Other Capital Gain Notes

Qualified Farm Property Acquired Prior to June 18, 1987

- property acquired before this date is eligible for the capital gains exemption if the following conditions are met:
  - the property was used by the taxpayer or members of the taxpayer's family in the business of farming for at least five years and;
  - was owned by the persons as defined under qualified farm property on the top of page three.

Qualified Farm Property Acquired after June 18, 1987

- The property must have been used by the taxpayer or member's of the taxpayer's family in farming for at least 24 months and must be in farming at the time of the sale.
- The individual using the property must be receiving gross revenue from farming higher than the net income from other sources.

Rollovers

There are special rules that allow you to defer capital gains on farm assets. They apply to the transfer of property to a spouse, child, Canadian corporation or Canadian partnership. This provides a way to decrease or completely defer a capital gain or recapture of capital cost allowance on depreciable farm property.

The following types of properties qualify for the rollover provision:

- Farmland
- Depreciable property such as buildings and machinery
- Eligible capital property such as quotas.

Depreciable property can be transferred at any amount between its undepreciated capital cost and it's fair market value. In order to qualify for this rollover provision, the property must be actively farmed by you, your spouse or any of your children on an ongoing basis before the transfer. ***For Further information refer to Information Update: Taxation – Property Transfers.***

Additions to the Adjusted Cost Base

There are some situations where the cost base of property can be increased. As per our previous example, if the cost base is increased, this will decrease the potential capital gain.

For farmers this is applicable where a farm loss is added to or created by paying interest or taxes. The restricted farm loss rules state that in this case the taxes and interest payments can be added to the cost base of the capital property for the purposes of determining eventual capital gains.

Based on our previous example, if there was a farm loss over the past two years, the mortgage interest and taxes of $10,000 per year can be added to the cost base.
Using our page five, land sale example:

Adjusted Cost Base of N ½ 1-1-1- ZPM	-	$50,000
Cumulated Interest and Taxes	-	$20,000
Adjusted Cost Base of N ½ 1-1-1-ZPM	-	$ 70,000

Deductions from Capital Gains Exemption to be aware of:

- The **annual gains** limit is calculated each year to determine if the individual can use all or a portion of the capital gains exemption.
- The **cumulative gains limit** is the running total of the individual's use of the capital gains exemption and indicates the permitted remaining deduction.

Cumulative Net Investment Loss (CNIL) is based on the principle that if you borrow money to buy a rental property, and the interest and other costs of your investment exceed the income from it, creating a deduction for tax, you should then not be able to sell the property for a tax free capital gain.

In theory, since 1988 the CNIL account is to be calculated every year and is submitted on Form T936. It is not sufficient to calculate this when a capital gains exemption occurs as you stand to lose the benefit of the income calculations if you should have losses. The recommendation is that an individual should complete the calculation every year even if they are not going to claim the capital gains exemption.

CNIL Example: The taxpayer purchased 80 acres with a house in 1998. The house is rented at $3000/year. Interest and taxes allocated to the house are $6,000 per year.

Net Rental Income ($3,000 - $6,000)	-	($3,000)
Deduction from other income each year	-	$3,000
Addition to CNIL each year	-	$3,000
CNIL at end of 1999 (2 x $3000)	-	$6,000

The CNIL balance of $6,000 is recorded on Form T936 and also entered on the calculation of the Capital Gains deduction for the taxation year on Form T657. *The net effect is that , upon the sale of the property, the CNIL balance will reduce the capital gains deduction resulting in an increase in taxable income.*

Summary

From the basic examples provided by this Information Update, the tax liabilities that can occur under Capital Gains are clearly illustrated, as well as how this must be taken into account when disposing of property. ***Because of the complexities and different scenarios that can arise when transferring or selling property it is strongly recommended that both legal and accounting professionals be consulted.***

For Further Information Contact Your Local Manitoba Agriculture Office.

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Tax Planning Worksheet
Based On 2000 Tax Calculation Assumptions

		2000
Income		
Farming Income		$25,000
Inventory		
Less: Opt Inventory Adjustment		$0
Breeding Stock		
Capital Recapture		$0
Capital Gain	$80,000	
Taxable Capital Gains	50%	$40,000
Total Income		**$65,000**
Less: RRSP contributions		$0
Net Income		**$65,000**
Less: Capital Gains Deduction		$40,000
Taxable Income		**$25,000**
Less: Personal Amounts		
Basic Amount		$7,181
CPP Contributions (estimate)		$1,677
Total Personal Amounts		**$8,858**
Personal Credits @ 17%		$1,506
Charitable Donations		
Credit For First $200 @ 17%		$0
Credit For Remainder @ 29%		$0
Total Non-Refundable Credits		**$1,506**
Calculation Of Federal Tax:		
17% On The First $29,797		$4,250
25% On The Next $29,797		$0
29% On The Remainder		$0
Total Federal Tax		**$4,250**
Less: Non-Refundable Tax Credits		$1,506
Basic Tax (before ATM)		**$2,744**
Alternative Minimum Tax Payable		**$0**
BASIC FEDERAL TAX		**$2,744**

Calculation Of Provincial & Total Tax

New Manitoba 2000 Budget Tax Calculation

8% on the first $29,950 ($25,000)		$2,000
12.22% on the next $29,950		$0
13.63% on the balance over $59,180		$0
2000 Provincial Tax Payable		$2,000
Add:Manitoba Net Inc. Tax @ 2%	($65000)	$1,300
Add: Manitoba Surtax		$700
Less: Manitoba Tax Reduction		$0
Provincial Tax Payable		**$4,000**
Add: Federal Surtax		$0
CPP Contibutions		$1,677
Total Tax Payable For Year		**$8,421**

Tax Planning Worksheet A
Based On 2000 Tax Calculation Assumptions

			2000
Taxable Income			**$25,000**
ADD: Net Contributions To Plans			
RRSP Deductions			0
ADD: Non-Taxable Portion of Capital Gains			
Net Total Capital Gains	**$80,000**		
Net Non-Taxable Part of Capital Gains	**50%**		$40,000
Adjusted Taxable Income			$65,000
Less: Basic Exemption			$40,000
Net Adjusted Taxable Income			$25,000
Federal Tax		@	**$0**
Gross Minimum Amount			$4,250
Less: Non-refundable Tax Credits			$1,506
Minimum Amount			$2,744
Regular Federal Tax Before Surtax			$2,744
Alternative Minimum Tax			**$0**